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Monetary unions and regional trade in Africa

Note by the UNCTAD secretariat

Executive summary

African regional economic communities (RECs) have bold plans to establish monetary unions as part of a broader effort to promote regional trade and integration. This paper welcomes these initiatives but stresses that the realization of the potential trade benefits of monetary unions in Africa is not automatic. In particular, monetary unions will contribute to stimulating trade in Africa if African Governments strengthen efforts to improve infrastructure, develop productive capacities, and enhance implementation of regional trade agreements. This paper also suggests that there are important lessons to be learned for African Governments from the recent experience and challenges of the European Monetary Union (EMU).

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Introduction

1. African Governments are strengthening efforts to build productive capacities and transform their economies with a view to laying a better and more robust foundation for sustained growth, employment creation and poverty reduction on the continent. Regional trade and cooperation is expected to play a crucial role in achieving the transformation agenda. It can unlock Africa's manufacturing potential through, for example, facilitating the development of infrastructure that would lower trade costs and make manufacturing more competitive. It can also promote economic transformation because the composition of intra-African trade tends to be skewed more towards manufactures than commodities, which dominate Africa's trade with the rest of the world. But African countries trade very little among themselves, as evidenced by the very low share of regional trade in Africa's total trade.[1]

2. Several steps have been taken by African Governments to promote intra-African trade. For example, in January 2012 African leaders made the decision to fast track the establishment of a Continental Free Trade Area. Furthermore, there are plans by several RECs to establish monetary unions as part of a broader effort to promote regional integration. For example, the Common Market for Eastern and Southern Africa, the Economic Community of West African States, the Southern African Development Community and the East African Community have all produced blueprints for establishing their own monetary unions. In the Economic Community of West African States region, six countries (Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone) are working towards establishing a common currency zone, namely the West African Monetary Zone,[2] by 2015, and the plan is that it will eventually be merged with the existing West African Economic and Monetary Union, whose eight members currently use the CFA franc. In the East African Community, the leaders of the five member countries[3] signed a protocol in November 2013 laying the groundwork for a monetary union within 10 years. In the Southern African Development Community, the plan is to establish a monetary union by 2016 and to have a single currency by 2018. With regard to the Common Market for Eastern and Southern Africa, members are working towards establishing a monetary union with a common currency by 2018. These regional initiatives are expected to result, ultimately, in the establishment of an African economic and monetary union as envisaged in the Abuja Treaty of 1991.

3. While there is heightened interest in monetary integration in Africa, it is important to stress that monetary unions are not new on the continent. Africa has a long history of some countries sharing single currencies. For example, there exists the West African Economic and Monetary Union (Union économique et monétaire ouest-africaine) with members using the West African CFA franc previously pegged to the French franc and now to the euro. There is also the Economic and Monetary Community of Central Africa, which is a custom and monetary union among former French Central African countries that use the Central Africa CFA franc currently pegged to the euro. Africa is also home to the

[1] In 2011, intraregional trade was about 11 per cent of Africa's total trade. Some of the factors inhibiting regional trade in Africa include high trade costs, lack of diversification, the phenomenon of informal trade, high tariff and non-tariff barriers, and political instability. See: UNCTAD, 2013, *Economic Development in Africa Report 2013. Intra-African Trade: Unlocking Private Sector Dynamism* (United Nations publication, sales No. E.13.II.D.2, New York and Geneva).

[2] The West African Monetary Zone was created in April 2000 with the signing of the Accra Declaration by the leaders of Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone.

[3] The members are Burundi, Kenya, Rwanda, Uganda and the United Republic of Tanzania.

Common Monetary Area, within which the domestic currencies of Lesotho, Namibia and Swaziland are pegged at par to the South African rand, which effectively means that they share the same monetary policy.

4. One of the main objectives of pursuing monetary unions in Africa is to boost regional integration, particularly intraregional trade and investments. Despite the efforts that have been made to promote regional integration on the continent Africa has not made much progress, particularly in fostering regional trade as evidenced by the low shares of intraregional trade in total trade. Over the period 2007–2011, the share of intraregional exports in total exports was 11 per cent for Africa, 21 per cent for Latin America and the Caribbean, 50 per cent for Asia, and 70 per cent for Europe. In this context, one of the challenges facing African countries is how to foster regional trade. This paper examines how the establishment of monetary unions in Africa can contribute to the achievement of the objective of promoting regional trade. More specifically, it explores the relationship between monetary unions and regional trade and discusses recent evidence on the relationship based on data for African countries. It also highlights the challenges facing African countries in effectively using monetary unions to promote regional trade and draws useful lessons for Africa from the experience of the EMU.

I. Can monetary unions enhance intraregional trade in Africa?

5. Since the successful launch of the euro in 1999, there has been considerable interest and debate on monetary unions in Africa. The discussions and analyses rely heavily on the concept or framework of an optimum currency area (OCA) based on the seminal work of Mundell.[4] According to the OCA literature, there are costs and benefits associated with the formation of monetary unions. The main benefit is that it reduces transaction costs, while the main cost is that members lose the possibility to use the exchange rate as an instrument for adjusting to asymmetric shocks. Given this trade-off the literature on OCA stresses that a group of countries are likely to form a successful monetary union if they have labour mobility across countries; wage and price flexibilities; similar economic structures; diversified production and export baskets; more open economies defined in terms of the ratio of tradable to nontradable goods; and a fiscal transfer mechanism to help countries adjust to asymmetric shocks.[5, 6] These ideas emanating from the traditional OCA literature formed the basis for empirical studies attempting to determine the feasibility of monetary unions in African regional economic communities. While this literature is vast, growing and interesting, we do not attempt to review it here because the key focus of this paper is not on whether or not monetary unions are feasible in Africa. Rather the paper focuses on a much narrower question, namely, given that African countries have decided to establish a monetary union, how can they ensure that such a union will contribute to the objective of promoting regional trade on the continent.

6. The economic literature suggests that a monetary union involving a common currency can enhance regional trade because it saves on the transaction costs of exchanging currencies, synchronizes business cycles, and enhances exchange rate and macroeconomic stability. In addition, a common currency increases price transparency and facilitates movement of capital between members, thereby fostering investment and trade.[7, 8]

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[4] RA Mundell, 1961, A theory of optimum currency areas, *American Economic Review*, 51:657–665.

[5] PB Kenen, 1969, The optimum currency area: An eclectic view, in: RA Mundell and AK Swoboda, eds., *Monetary Problems of the International Economy*, University of Chicago Press, Chicago.

[6] R McKinnon, 1963, Optimum currency areas, *American Economic Review*, 54(3):712–725.

[7] P De Grauwe, 2009, *Economics of Monetary Union*, eighth edition, Oxford University Press, Oxford and New York.

Empirical studies have also confirmed the trade-enhancing impacts of monetary unions. Using data for a large number of countries, Rose[9] found that on average countries in a monetary union trade three times more than countries with different currencies. Although the methodology adopted by Rose has been criticized by some authors, the trade-enhancing impact of monetary unions has been confirmed by other empirical studies using different methodologies.[10, 11, 12, 13]

7. Empirical evidence based on data for African countries also provides strong support for the view that monetary unions enhance trade. For example, Masson and Patillo[14] found that currency unions have a positive impact on trade in Africa. In addition, Tsangarides et al.[15] found that currency unions have a significant trade-generating effect in Africa. On average, currency union was found to increase trade in Africa by a factor of 1.4. The study also found that the duration of currency union membership also matters for trade in Africa in the sense that the longer a country participates in a union the greater the benefit it obtains. While there is evidence that monetary unions can enhance regional trade in Africa, it should be noted that the relationship between monetary unions and trade can be bidirectional. For example, monetary unions can create trade, and the promotion of trade through regional integration can also create conditions more suitable for monetary integration. In this context there is the need for African Governments to make the two processes mutually reinforcing to maximize their impact and contributions to the development process.

II. Making monetary unions foster regional trade in Africa

8. The finding that monetary unions can promote trade does not mean that it is a panacea to Africa's regional trade and development challenges. In particular, it is not a sufficient condition for fostering regional trade in Africa. In this regard, if African Governments want to use monetary union effectively to promote trade they will have to adopt complementary economic policies that would create favourable conditions for stimulating regional trade. The potential trade-enhancing impact of monetary unions is likely to be realized in Africa if more efforts are made to develop countries' productive capacities. A monetary union can reduce trade costs among members, but if the members do not have the capacity to produce the types of goods that consumers want, it is unlikely to generate sufficient trade between them. The provision and accessibility of reliable infrastructure and better access to affordable credit are some policy measures that can contribute to the development of productive capacities in Africa.

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[8] P Krugman, 1993, Lessons of Massachusetts for EMU, in: F Torres and F Giavazzi, eds., *Adjustment and Growth in the European Monetary Union*, Cambridge University Press, Cambridge, pp. 241–269.

[9] A Rose, 2000, One market, one money: Estimating the effect of common currencies on trade, *Economic Policy*, 30:9–45.

[10] R Glick and A Rose, 2002, Does a currency union affect trade? The time-series evidence, *European Economic Review*, 46(6):1125–1151.

[11] M Obstfeld and K Rogoff, 2000, Do we really need a new international monetary compact? National Bureau of Economic Research Working Paper Series No. 7864, August.

[12] T Persson, 2001, Currency union and trade: How large is the treatment effect? *Economic Policy* 33:433–448.

[13] R Thom and B Walsh, 2002, The effect of a common currency on trade: Ireland before and after the sterling link, *European Economic Review*, 46:1125–2351.

[14] P Masson and C Patillo, 2005, *The Monetary Geography of Africa*, Brookings Institution Press, Washington, D.C.

[15] C Tsangarides, P Ewenczyk, M Hulej and M Qureshi, 2008, Are Africa's currency unions good for trade? International Monetary Fund Staff Papers, 56(4).

9. The existence of high tariff and non-tariff barriers in Africa is also a major obstacle to boosting regional trade and this issue has to be addressed to unlock the potential of monetary unions to stimulate trade in Africa. This will require better implementation of regional trade agreements by African countries and the introduction of a monitoring mechanism to measure the extent to which members comply with regional agreements will play a positive role in compelling members to abide by the agreements they signed. There is also the need to ensure that the benefits of regional trade accrue to all members to create an incentive for each member to remove existing barriers to this regional trade and create an environment conducive to promotion of regional trade through monetary unification.

10. The stability and duration of monetary unions also play a role in determining the impact of monetary unions on trade. A more stable and durable monetary union is likely to reduce uncertainty and stimulate investment and regional trade. It can also create more opportunities for risk sharing and better allocation of capital, and promote economic growth in its member countries. But for monetary unions to be stable and durable it is important that a mechanism is in place to ensure that members of the union achieve macroeconomic stability. Misalignment of macroeconomic variables can create financial crises in the union, threaten its survival, and make it challenging to foster regional trade. In this context, there is the need for harmonization of economic policies to reduce the likelihood of macroeconomic divergence across countries in the union.

III. Lessons from the Eurozone for Africa

11. Africa has a longer history of monetary unions than Europe, but the large size of the EMU and the challenges it has faced since the "Great Recession" of 2009 provides important lessons for both existing and proposed monetary unions in Africa. Unlike in Africa, Europe already had a relatively high degree of trade integration before the establishment of the EMU. It also has very good, reliable and accessible infrastructure. It is therefore not surprising that the impact of the EMU on trade has been quite significant. One of the key lessons for Africa from this experience is that the trade and institutional environment has to be conducive to fostering regional trade to ensure that the potential benefits of monetary integration on trade are fully realized.

12. Another lesson from the EMU for Africa is the importance of stable macroeconomic policies. When there are wide differences in the degree of fiscal discipline across member countries it can create challenges for the survival and stability of the union. To address this issue, RECs in Africa have imposed macroeconomic convergence criteria, following closely the approach adopted by members of the EMU. There are concerns that the adoption of the stringent EMU type of convergence criteria will limit the policy space that African countries have to address their current and emerging development challenges. There is also the view that most members of the RECs working towards monetary integration are having difficulties meeting the established convergence criteria, suggesting that the criteria may be too strict given the development needs and challenges of the continent. An assessment of progress towards macroeconomic convergence in RECs shows that, while some progress is being made, it is generally below the targets set in their financial integration programmes.[16]

13. The EMU experience also underscores the need for countries that are about to participate in a monetary union to have a credible and feasible mechanism for fiscal

[16] African Development Bank, 2012, Supporting macroeconomic convergence in African RECs, Regional Integration Policy Papers No. 001-December, African Development Bank Department of NEPAD, Regional Integration and Trade Department.

transfers to enable them to respond and adjust to asymmetric shocks. In the absence of such a mechanism, the monetary union will be susceptible to enormous pressure when its members are hit by such asymmetric shocks. Labour mobility can also play a crucial role in helping countries adjust to asymmetric shocks but it is challenging and difficult to implement and requires enormous political will on the part of leaders.

IV. Conclusions and questions for discussion

14. African Governments plan to establish an African economic and monetary union involving the use of a single currency issued by a common central bank with a view to fostering regional trade and integration. The RECs are expected to play a crucial role in achieving the goal of monetary integration, as outlined in the Abuja Treaty of 1991, and many of them have prepared timetables with respect to their monetary and financial integration. The literature suggests that monetary unions have the potential to contribute to the promotion of regional trade, and recent empirical studies that have examined this relationship using African data have confirmed that this would be the case for Africa. Nevertheless, it is argued in the present paper that the relationship between monetary unions and trade is not automatic and that complementary policies are needed to improve infrastructure, build productive capacities, remove trade barriers, and ensure that the full impact of monetary unions on trade are realized in Africa.

15. Against this backdrop, the following issues have been identified to guide the panel discussion on the theme of this year's executive session of the Trade and Development Board:

1. Are monetary unions necessary or sufficient for the promotion of regional trade and integration in Africa?

2. What should African Governments and their development partners do to ensure that the establishment of monetary unions in Africa will foster regional trade and integration?

3. Are there lessons for Africa from the EMU and the recent Eurozone crisis?